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Interest Rate Benchmark Reform – Phase 2 Cover Note

Objective

- 1 This session is to approve for publication the pre-consultation letter on the tentative decisions the IASB has taken on IBOR Phase 2.

Background

- 2 The pre-consultation letter was discussed at FIWG during the web conference on 12 March 2020. The related agenda paper 06-02 reflects the input obtained during this discussion.
- 3 In particular, FIWG has intensively discussed several issues but decided against amending the pre-consultation letter in the following regards:

Clarification of modification (IASB tentative decision 1):

- 4 FIWG members discussed whether the pre-consultation letter should include a statement whether EFRAG agrees or disagrees with the proposed clarification on what constitutes a modification.
- 5 EFRAG FIWG observed that the proposed clarification primarily arises from the IASB's intention to broadly clarify the definition of a modification (also beyond the IBOR reform); however members did not believe that there is divergence in practice. EFRAG FIWG noted that taking position on this clarification could imply that EFRAG acknowledged divergence in practice that cannot be observed.
- 6 While some EFRAG FIWG members had a preference for expressing concern on the proposed clarification, it was observed that, in the limited context of IBOR, the clarification would not have an impact because the practical expedient to apply paragraph B.5.4.5 of IFRS 9 applies.
- 7 In case the IASB will discuss the proposed clarification in the future within a general context outside IBOR, there will be an opportunity for EFRAG to revisit this discussion and comment as appropriate.
- 8 Thus, EFRAG FIWG concluded that the current drafting where EFRAG "notes" the proposed clarification is already sufficiently neutral and should be maintained.

Other IFRS Standards (IASB tentative decision 5):

- 9 EFRAG FIWG discussed whether an issue would arise in the context of fair value measurements classified as level 3 when the input parameters for an alternative benchmark rate were not sufficiently observable yet. If so, a difference between transaction price and fair value may arise (commonly referred to as “day one gain or loss”). Such difference is only recognised in profit or loss on initial recognition if it is evidenced by a quoted price in an active market. When this is not the case for an alternative benchmark rate, EFRAG FIWG observed that such difference would be deferred until (and no later than) when the alternative benchmark rate becomes observable.
- 10 EFRAG FIWG also observed that the issue of day-one gains or losses will only arise for instruments that are initially recognised. However, when transitioning from IBOR to an alternative benchmark rate and the contractual cash flows are modified as directly required by the reform, entities will apply the practical expedient to apply paragraph B5.4.5 of IFRS 9. Thus, no derecognition event will occur and hence no issue of day-one gains or losses will arise for existing contracts based on IBOR when transitioning to an alternative benchmark rate as directly required by the reform. In addition, also when derecognition would apply, when a subsequent observable market price appears, the deferred day-one gain would be recognised.
- 11 Against this background, EFRAG FIWG concluded that the issue of day one gains or losses in the context of IBOR reform should not be raised in the pre-consultation letter.

SIRM criteria (IASB tentative decision 7):

- 12 EFRAG FIWG discussed whether the proposed amendment on the separately identifiable criterion was useful in practice, when there was not corresponding relief to the reliably measureable criterion. Some FIWG members observed that usually the two criteria are interconnected, so granting relief only to one of the criteria may still not meet the eligibility criteria because of failure of the other criterion.
- 13 The assessment of those criteria will always depend on the specific facts and circumstances for a risk component in respect of a particular alternative benchmark rate, e.g. in respect of the respective cash and derivative market. Against this background, some FIWG members noted that the proposed amendment could have the potential to create undue complexity and entities may already be able to deal with the issue without any amendment in this regard.
- 14 However, because the separately identifiable criterion for non-contractually specified risk components is assessed against the market for cash instruments based on alternative benchmark rates, EFRAG FIWG observed that a relief on this criterion is useful because the cash market may not be sufficiently established in the early stages of the reform.
- 15 EFRAG FIWG also observed that the extension of the relief period to 24 months instead of 12 months is expected to mitigate the concerns expressed in an earlier discussion in that entities may have a disincentive to transition to an alternative benchmark rate in the early stages of a reform.
- 16 EFRAG FIWG members were sympathetic of the IASB’s reasoning of granting no relief regarding the reliably measureable criterion because of the fundamental nature of reliable measurement in the context of hedge accounting.

Questions for EFRAG TEG/CFSS/User Panel/Board

- 17 Does EFRAG TEG have comments on the reasoning of EFRAG FIWG in respect of
- (a) Clarification of modification (IASB tentative decision 1);
 - (b) Other IFRS Standards (IASB tentative decision 5);
 - (c) SIRM criteria (IASB tentative decision 7)?

Agenda Papers

- 18 In addition to this cover note, agenda paper 06-02 – *Draft Pre-Consultation Letter on IBOR Phase 2* – has been provided for the session.